

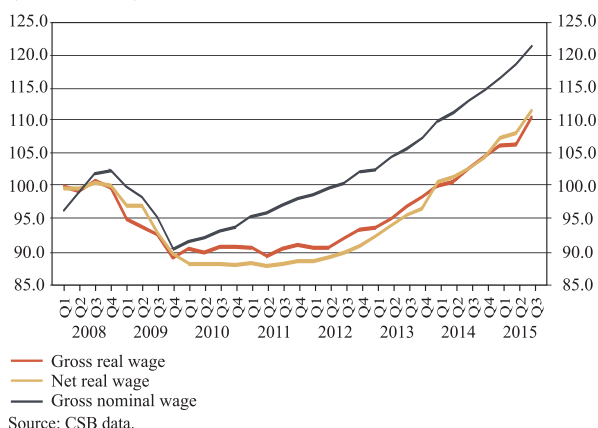


LATVIJAS BANKA
MONTHLY NEWSLETTER

DECEMBER 2015

Wage growth continues

Wage index
(Q4 2008=100)

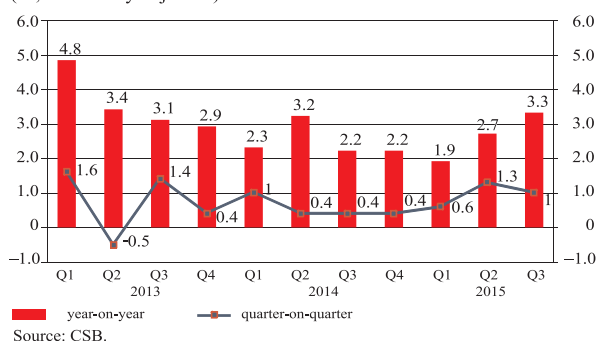


The latest data indicate that the average gross monthly wage for full-time employment in the third quarter of 2015 rose by 7.3% year-on-year. Although consumer prices have dropped during the year and the tax burden on labour income has been reduced, the purchasing power of an average wage (or real net wage) has increased by 8.3%. This bolstered private consumption dynamics amid conditions of weak external demand. The private sector is still playing a leading role in raising wages. It increased the average gross nominal wage by 8.3%, but the public sector – by 5.4%.

Wage growth is expected to abate next year. The deceleration in the rise of net real wage will be faster than that of gross nominal wage, and labour income will not support private consumption to the extent seen so far. This will highlight the significance of external demand and competitiveness in economic development.

Private consumption behind GDP growth

Real GDP growth rate
(%; seasonally adjusted)



According to the data of the Central Statistical Bureau (CSB), gross domestic product (GDP) of Latvia in the third quarter of 2015 increased by 1.0% quarter-on-quarter and 3.3% year-on-year. GDP grew faster than projected in the flash estimate published at the end of October.

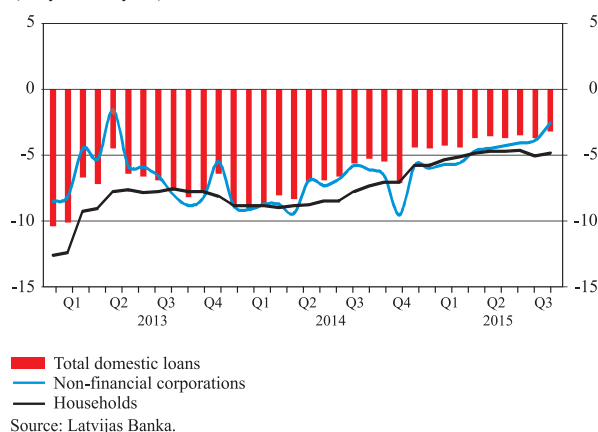
Similar to the previous quarter, in the third quarter it was again private consumption that contributed substantially to economic growth, increasing by 5.2% year-on-year. The strengthening in private consumption was primarily bolstered by the rise in disposable income, which reflects a pick-up in real net wages. The available information on retail volumes, which continued to edge up in the third quarter, had already shown that private consumption would

grow. Although the total consumer confidence indicator decreased in the third quarter, the population's vision of its financial situation remained positive. This shows that a pronounced fall in private consumption is not expected, at least in the near future.

As in 2015, private consumption will primarily remain the major driver of growth in the next quarters. Yet we have to reckon with the fact that such strong wage rises may not be possible in the long term. With this increase moderating, the question of how to promote export expansion and maintain investment growth will once again come to the forefront.

Situation in lending is improving

Loans to the private sector
(%; year-on-year)







Although no radical changes in money indicators were observed in October, almost all lending-related indicators improved slightly, i.e. the loan portfolio either increased in absolute terms or at least the annual rate of decrease in loans decelerated.

In October the domestic loan portfolio of banks increased by 0.1%, including loans to non-financial corporations which rose by 0.4%, while loans to households dropped by 0.2%. The annual rate of decrease in domestic loans in October was -3.2%, including -2.7% regarding loans to non-financial corporations and -4.9% in relation to loans to households.

The long-expected positive developments in lending are gradually taking shape. Recovery in lending to businesses has begun. New loans are increasing, and the total loan portfolio has slightly expanded in the first ten months of 2015. In the household sector, consumer lending has edged up this year,

while the contraction rate in housing loans has slowed. Banks are of the opinion that the environment for housing loans is currently favourable in Latvia and mortgage loans will grow next year. Lending to households will also be fostered by the projected low interest rates and a rise in the population's income.

| | Reporting period | Data (%) |
|---|------------------|----------|
| Gross Domestic Product (GDP) | | |
| Real GDP (year-on-year growth) | 2015 Q3 | 3.3 |
| Real GDP (quarter-on-quarter growth; seasonally adjusted) | 2015 Q3 | 1.0 |
| 01.12.2015 Private consumption behind the GDP growth  | | |
| Public Finances | | |
| General government budget expenditure (since the beginning of the year, year-on-year growth) | 2015 XI | 3.6 |
| Tax revenue (since the beginning of the year; year-on-year growth) | 2015 XI | 5.0 |
| Consumer price changes | | |
| Consumer Price Index CPI (year-on-year growth) | 2015 XI | 0.0 |
| Consumer Price Index HICP (year-on-year growth) | 2015 XI | 0.0 |
| 12-month average inflation (HICP) | 2015 XI | 0.2 |
| 09.12.2015 Annual inflation slowly moves out of negative territory  | | |
| Foreign trade | | |
| Exports (year-on-year growth) | 2015 X | -6.5 |
| Imports (year-on-year growth) | 2015 X | -8.6 |
| 12.12.2015 Export growth by branch is fragile and unstable  | | |
| Balance of payments | | |
| Current account balance (ratio to GDP) | 2015 Q3 | -3.0 |
| Foreign direct investment in Latvia (net flows; ratio to GDP) | 2015 Q3 | 2.5 |
| 04.12.2015 In the third quarter, the current account deficit was 190.3 mil. euro  | | |
| Industrial output | | |
| Working day-adjusted manufacturing output index (year-on-year growth) | 2015 X | 0.0 |
| 08.12.2015 After the recent acceleration, some slowdown in manufacturing observed  | | |
| Retail trade turnover | | |
| Retail trade turnover at constant prices (year-on-year growth) | 2015 X | 5.7 |
| Labour market | | |
| Registered unemployment (share in working age population) | 2015 XI | 8.4 |
| Job seekers rate (share in working age population) | 2015 Q3 | 9.7 |
| 30.11.2015 Wage growth continues  | | |
| Monetary indicators | | |
| Resident deposits (year-on-year growth) | 2015 X | 9.1 |
| 30.11.2015 Situation improving in lending  | | |

Sources: Treasury, Central Statistical Bureau of the Republic of Latvia, and Latvijas Banka data.

The right moment to put the budget in order

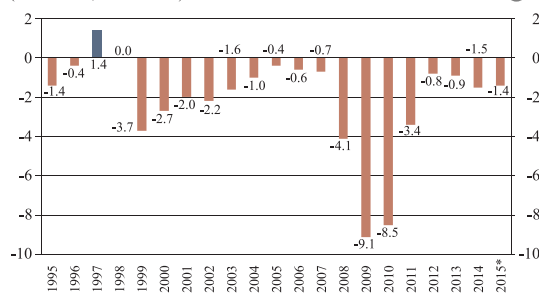
Press conference of the Governor of Latvijas Banka (summary)



Ilmārs Rimšēvičs
President
Latvijas Banka

This is a crucial moment for establishing a reasonable fiscal policy and putting the budget in order, said Ilmārs Rimšēvičs, the Governor of Latvijas Banka, at his regular press conference in December. For 2017, a budget ensuring a solid foundation for Latvia's future economic growth should be adopted. This should be achieved based on several principles: stability, balanced budget, and careful revision of budgetary expenses (zero-based budgeting).

General government budget balance in Latvia
(% of GDP, ESA 2010)



* Assessment by the Ministry of Finance
Source: Eurostat



The 2016 budget has been adopted despite all the shortcomings so much discussed by entrepreneurs, and we will have to live with it. So right now it is important to not lose time and review the budget drafting process, so that we could adopt the kind of budget for 2017 that would create a stable foundation for the development of Latvian economy in the future.

Stability is essential for the Latvian business environment, for attracting investment and for resuming lending. Latvijas Banka supports the proposal of auditing the tax system, at the same time urging to make it clear once and for all: as soon as the taxation system is put in order, we are not going to manipulate it for at least one general election cycle. Thus a practice of a stable and transparent tax system would be

established – a system that, instead of being changed every year, is maintained stable for at least four years. The tendency of the last twenty years is worrisome: we have had a budget surplus for only one year; the rest of the time we have lived on debt, increasing the external debt. Still the simple equation is valid: **budget deficit = higher public debt = higher taxes**. In other words, living with a budget deficit we enter a vicious circle: the public debt is growing and to service it greater funds are needed, but, to find these funds, taxes have to be raised. The raising of taxes has a negative influence on the business environment, it is an obstacle to investment and creates uncertainty about the future both for businesses and households, thus having a negative impact both on economic growth and the budget itself.

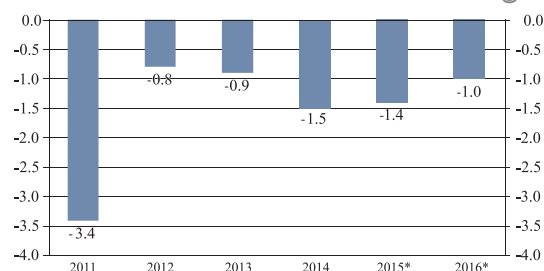
**"Still the simple equation is valid:
budget deficit = higher public debt =
higher taxes."**

The promise of **establishing a working group for zero budget** should be kept, irrespective of what is happening with the coalitions, governments, etc. Any budget activity must be evaluated from the beginning – by assessing the relevance of positions rather than increasing the base for the next years without carefully reviewing the expenditure of previous years. In this work, there should be no red lines: the budget base should be evaluated in all ministries, including the priority ones, whose expenditure was not curtailed for 2016.

The current lack of discipline has consequences for the future. Regarding 2016, no prior commitments were honoured, which means that for 2017, a greater fiscal reserve will have to be built. In view of the optimistic forecasts, which have been included in the budget but which may have to be corrected – because of lower inflation, among other things – **building the fiscal reserve will be very important**.

Under the current circumstances, **structural reforms in education and healthcare systems are of growing importance**. We do hope that in 2016 serious reforms will take place in both of these areas, in order to improve

General government deficit
(% of GDP)



* Assessment by the Ministry of Finance
Sources: Eurostat, Law on the state budget for 2016



Latvia's competitiveness, and that measures will concurrently be taken to explain to the general public why such reforms are necessary and what positive effect they will have on our economy in the future.

Why are we discussing budget matters already now? We have at least six months till the drafting of the next budget begins and we hope that the Ministry of Finance and the Government will launch a serious discussion for us to see what the Government is spending overall and whether the only way to improve the budget situation is to continue brutally raising the taxes. That's not the way it should be.